



## Trust Severances and Other Planning Under the New Final and Prop. GST Regs.

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In 2004, the IRS published Proposed Regulations regarding qualified severances of trusts for federal generation-skipping transfer ("GST") tax purposes.<sup>1</sup> Three years later, the IRS now has issued final Regulations<sup>2</sup> along with new Proposed Regulations<sup>3</sup> covering other aspects of qualified severances. The *final* Regulations resolve some of the problems raised by the 2004 Proposed Regulations, and the new *Proposed* Regulations address a few other issues related to qualified severances. These Regulations continue to apply only to the GST consequences of a qualified severance and not to the possible estate, gift, or income tax effects of the severance (although the IRS did address the income tax consequences of certain qualified severances in a separate Regulation under Section 1001).

## Background

In planning for the GST tax, it is important to avoid creating trusts that are only partially exempt from that tax. If a transferor does not have enough GST exemption to make a trust fully exempt, the best planning results typically are obtained by creating two trusts—one entirely GST exempt and the other wholly GST taxable. By segregating exempt from nonexempt assets, a trustee can avoid the GST tax by making distributions to skip persons (grandchildren and more remote descendants) only from trusts that are wholly exempt from the tax, and conserving GST-exempt property by making distributions to nonskip persons (children or charities) from trusts that are not exempt. Segregated exempt and nonexempt trusts also allow a trustee to pursue different investment policies, such as emphasizing current income in the taxable trust and growth in the exempt trust. Notwithstanding this commonly desired result, and for a variety of reasons, trusts sometimes wind up being only partially exempt from GST tax.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provided appropriate help in this regard, by adding Section 2642(a)(3) to the Internal Revenue Code. That section provides that if a trust is severed in a "qualified severance," then the exempt and nonexempt portions of the original trust can be separated. The purpose of this was to

overturn the then position of the IRS that once a trust was partially exempt it could never be separated into exempt and nonexempt portions.

These "downstream splits" are accomplished through a "qualified severance," defined as a division of a single trust into two or more trusts by any means available under the governing instrument or local law but only if (1) the trust is divided on a fractional basis, and (2) the terms of the new trusts, "in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust." Moreover, as discussed later, the trust must be divided in a manner to create one trust that is wholly exempt from GST tax and the other trust that is wholly subject to that tax.

## The 2642(a)(3) Regs. do not supersede the 2654 Regs.

The major change between the Proposed and final Regulations relates to the creation of separate trusts at the death of an individual under Reg. 26.2654-1(b). That Regulation provides that the severance of a trust that is included in a decedent's gross estate will be recognized for GST purposes, retroactively to the decedent's death, if certain requirements are met.

Under that Regulation, if a trust is severed pursuant to a mandatory direction in the trust instrument, effective upon the transferor's death, the severed trusts automatically qualify. Absent an express direction, a discretionary severance as of the date of death also qualifies under that Regulation if (1) the severance is made pursuant to discretionary authority granted under either the instrument or local law, (2) the severance occurs (or court proceedings seeking severance are commenced) before the due date for the estate tax return (although funding of the trusts does not need to be completed by that due date), and (3) the terms of the new trusts provide, in the aggregate, for the same succession of interests and beneficiaries as are in the original trust. Unless the trust instrument directs that severance be done on a pecuniary basis, a severance must also be done on a fractional basis.

The 2004 Proposed Regulations had expressly superseded Reg. 26.2654-1(b). This raised questions about pecuniary bequests at the death of an individual. If the prior Regulation had been superseded, there would have been no clear confirmation that a pecuniary gift from an existing revocable trust at death, or the residue left after that pecuniary gift, would qualify as a separate share to which GST exemption could be allocated based on its value as of the date of death.

The final Regulations backed off of this position. The prior Regulation will continue to apply to situations in which the trust is includable in the transferor's gross estate and the severance, by the terms of the trust, is to apply retroactively to the date of the transferor's death. The new Section 2642(a)(3) rules will apply only to a "downstream" qualified severance of a trust (regardless of whether the trust is included in the transferor's estate) if the severance does not qualify under Reg. 26.2654-1(b). 4

#### Requirements of a qualified severance

Generally, the requirements for a downstream qualified severance 5 have not changed significantly from the 2004 Proposed Regulations. The trust must still be severed pursuant to the terms of the governing instrument or local law, and must be effective under local law. The trust must be severed on a fractional basis, with each new trust funded with a fraction or percentage of the original trust. Severance of a trust on a pecuniary basis will not be considered a qualified severance.

The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. In addition, if the trust being severed is one to which some GST exemption has already been allocated, then the initial severance must be into two trusts, one with an inclusion ratio of zero and one with an inclusion ratio of one. Once that is done, the resulting trusts may be severed further (along family lines, for example). The final Regulations provide that in such event, each trust created from the severance will

have the same inclusion ratio (either zero or one) as the trust being severed.

The final Regulations add another requirement related to non-pro rata funding of the severed trusts, which is permitted under certain circumstances. Under the 2004 Proposed Regulations, if non-pro rata funding was to be used, each resulting trust had to be funded by applying the appropriate fraction or percentage to the total fair market value ("FMV") of the assets of the trust as of the date of funding. Concerns were raised over how this could be applied to the common situation where funding occurs over a period of time and not on one date.

The final Regulations address this by providing that the total FMV of the assets of the trust as of the date of severance can be used, and then defining "date of severance" as the date selected by the trustee to value the assets or the date selected by the court if a court is involved. 6 In either case, the funding must commence immediately upon, and occur within a "reasonable time" (no more than 90 days) after, the selected valuation date.

In the Preamble, the IRS states that a reasonable time may differ, depending on the type of asset involved. Accordingly, the 90-day limit should not be viewed as a safe harbor, because the IRS could challenge delays in funding of assets such as bank or brokerage accounts that generally can be retitled easily. This is confirmed in new Example 11 of Reg. 26.2642-6(j), in which the IRS states that if the only assets of the trust are cash and marketable securities, "then in order to satisfy the reasonable time requirement, the stock transfer would have to have been commenced, and generally completed, immediately after the date of severance, and the cash distribution would have to have been made at the same time." Limiting the period for funding to 90 days should minimize the ability of a fiduciary to wait and then use the assets that have appreciated the most since the "date of severance" for funding the exempt trust.

If a trustee decides to fund the severed trusts with the same pro rata share of each asset, there really will be no valuations required and delays in funding will have no impact on the relative values of the resulting trusts. Nevertheless, even in those circumstances, until clarified by the IRS, the cautious trustee will want to designate a date of severance and proceed to fund the trusts within a reasonable time thereafter.

The final Regulations also provide further guidance on the requirement that the beneficiaries of the resulting trusts must have the same succession of interests as were in the original trust. If the trust instrument does not define the beneficiaries' interests (*e.g.*, a "spray trust"), then the test is applied on a per capita basis, although the meaning of "*per capita*" in this context is not clear. <sup>7</sup>

The Regulations give an example of an original trust that is a discretionary spray trust for the three children of the grantor and their descendants. Theoretically, the trust assets could be distributed entirely to one individual or one family line. The remainder of the trust is divided equally among the three families. The example states that a division of the trust into three separate equal trusts, one for each family line, will satisfy this test. That sounds more like what most planners think of as a per stirpes division of the trust than a per capita one, and maybe that is how it should be interpreted.

It is not clear how far one can go in making the trusts different and still fit within this requirement. Example 3 in final Reg. 26.2642-6(j) discusses one situation that will not be considered the same succession of interests. In that example, an irrevocable trust, that is wholly nonexempt from GST tax, pays income to T's child C for life. Upon C's death, the remaining property is to be distributed to C's child, GC, if then living, or otherwise to GC's estate. The trustee later severs the trust into two trusts, one for C and one for GC and funds them based on the relative actuarial values of C's and GC's interests in the trust based on Section 7520. The example states that this is not the same succession of interests, and the severance will not be a qualified severance.

From a planning standpoint, it would be prudent to include in trust instruments a power that allows a trustee to sever trusts in a way that does not require identical trusts after the severance. State statutes may not offer this flexibility, and without it there may be legal impediments to severing a trust, for example, along family lines. However, even where the governing instrument or state law authorizes a severance, it still may not qualify, for example, in the circumstances described in the previous paragraph.

The 2004 Proposed Regulations had provided that reporting of the severance was necessary in order for it to be a qualified severance. This requirement might have opened an unintentional loophole. In some situations, it might be advantageous to sever a trust but not treat the severance as a qualified severance. For example, a trustee might split a trust being held for three children and their descendants into separate trusts for the different family lives, but wish to take advantage of the lives of all the children to postpone GST tax for as long as possible. If the severance is not a qualified severance, the trusts would continue to be treated as one trust for GST purposes, so the death of the first or second child would not cause a taxable termination in those trusts so long as the third child is still alive. Under the final Regulations, the reporting of the severance is no longer a requirement for qualification, <sup>8</sup> but the IRS still "expects" severances to be reported. The final Regulations also drop the requirement that red ink be used to write "Qualified Severance" at the top of the Form 706-GS(T).

#### Other clarifications

The final Regulations, including new Example 8 of Reg. 26.2642-6(j), make it clear that the qualified severance itself will not cause GST tax to be due. In that example, a trust with a inclusion ratio of .50 held for a child and grandchild of the transferor was severed into two equal trusts, one for the child and the child's descendants and one for the grandchild and the grandchild's descendants. After the severance, the child's trust had an inclusion ratio of one and the grandchild's trust had an inclusion ratio of zero.

Although the creation of the grandchild's trust ordinarily would constitute a taxable termination or distribution, the qualified severance is deemed to precede it. Thus, the qualified severance will not result in any GST tax being owed. On the other hand, a qualified severance will not retroactively save any taxable termination or taxable distribution that occurs prior to the severance. So, if the trustee makes a distribution to a grandchild from a partially exempt trust before the qualified severance occurs, there will be GST tax consequences resulting from that distribution.

The final Regulations also discuss a situation involving a grandfathered trust to which an addition was made. A "grandfathered" trust is a trust that was irrevocable on 9/25/85, when the GST law became effective. Grandfathered trusts are never subject to the GST tax unless they are modified in certain ways not permitted under the Regulations or unless additions are made to them after 9/25/85. If an addition is made to a grandfathered trust, a portion of the trust becomes subject to GST tax. Under existing Regulations, such a trust can be divided into two trusts—one that remains grandfathered and one that is subject to the GST rules (the taxable trust). The final Regulations provide that the taxable trust can then be severed pursuant to the qualified severance rules.<sup>9</sup> The grandfathered trust will continue to be exempt subject to the rules in Reg. 26.2601-(b)(4).

Another new example clarifies an issue related to contingent general powers of appointment that are often granted to a beneficiary in an attempt to minimize overall taxes that will be due at the beneficiary's death. In Example 10 of Reg. 26.2642-6(j), T transferred \$1 million to a trust and allocated \$400,000 of GST exemption. Under the terms of the trust, T's child C is given a contingent testamentary general power of appointment over the non-GST-exempt portion of the trust. The trustee severs the trust into two trusts, one with 40% of the assets and one with 60% of the assets.

Under these circumstances, the example concludes that the 40% trust will be GST exempt and the 60%

trust will be wholly subject to GST tax, but for the application of the contingent testamentary power. The example concludes that C will become the transferor of the 60% trust at his death, confirming that the contingent general power of appointment does prevent the GST tax from being owed (since it will instead be taxed in C's estate under Section 2041).

The IRS also added a new Example 3 to Reg. 26.2654-1(b) to confirm that a formula severance is effective for GST purposes. In that example, the executor reported in the estate tax return that he was severing a trust into two trusts. One of the trusts would receive a fraction of the assets, the numerator of which is \$1 million (which was the amount of the testator's remaining GST exemption) and the denominator of which is the value of the trust assets as finally determined for federal estate tax purposes. The other trust would receive the remaining assets. Assuming the other requirements for a qualified severance are met, this formula will be recognized for GST purposes so that the trusts are separate and GST exemption may be allocated entirely to only one of them.

**Effective date.** The final Regulations apply to all severances occurring on or after 8/2/07. For severances occurring after 12/31/00 and before 8/2/07, taxpayers are permitted to rely on any reasonable interpretation of Section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS. If notice of such a severance has not already been given, it should be reported by filing a Form 706-GS(T) "as soon as reasonably practicable after August 2, 2007."

### Income tax

The IRS has also adopted Reg. 1.1001-1(h) to cover the income tax consequences of a qualified severance. This Regulation provides that a severance of a trust and subsequent funding of the resulting trusts with different assets on a non-pro rata basis will not constitute an exchange of property if an applicable state statute or the governing instrument authorizes both the severance and the non-pro rata

funding, and if the non-pro rata funding is done as provided in the qualified severance Regulations, as previously discussed. However, this safe harbor may not cover all qualified severances since it refers only to those authorized by state statute or the trust instrument. Severances done by other means, such as reformations, are not expressly protected by the Regulation. Until the IRS modifies this, caution should be exercised in using non-pro rata funding for severances not specifically covered by this Regulation. Presumably however, the real issue is whether applicable "law" authorizes a non-pro rata severance, whether that be authorized by the instrument, statute or proper court ruling.

### New Proposed Regulations

At the same time that the IRS was publishing these final Regulations, it also published new Proposed Regulations under Section 2642. The new Proposed Regulations discuss a nonqualified severance of a trust. A nonqualified severance is a severance of a trust that meets the requirements of state law but not the requirements for a qualified severance.

For example, if a trustee accomplished a downstream severance of a partially exempt trust pursuant to a power granted in the trust instrument but funded one of the trusts on a pecuniary basis, the severance would not be considered a qualified severance. In such event, the trusts would be treated as separate trusts for GST purposes but each initially would have the same inclusion ratio as the original trust. However, the transferor could then allocate GST exemption to only one of the trusts in the future. Previously, the IRS position was that the trusts would not prospectively be treated as separate trusts for GST purposes, so any allocation of GST exemption after the severance would be deemed allocated to both trusts.

The Proposed Regulations also would allow a qualified severance into more than two trusts. <sup>10</sup> To accomplish this, one or more of the resulting trusts must receive in the aggregate that fractional share of the total value of the original trust as of the date of severance that corresponds to the inclusion ratio of

the trust immediately before the severance. For example, if the original trust's applicable fraction is  $\frac{2}{10}$ , then the trust could be split into three trusts, with one trust receiving  $\frac{5}{10}$  of the property, one trust receiving  $\frac{3}{10}$  of the property and one trust receiving  $\frac{2}{10}$  of the property. The trusts receiving  $\frac{5}{10}$  and  $\frac{3}{10}$  of the property would have an inclusion ratio of 0. The trust receiving  $\frac{2}{10}$  of the property would have an inclusion ratio of 1. Assuming the other requirements are met, the severance would be a qualified severance.

Finally, the Proposed Regulations would prohibit the use of valuation discounts that otherwise would arise because an asset of the original trust is divided between the two resulting trusts upon a non-pro rata funding. <sup>11</sup> For example, assume the original trust owns 60% of the common stock of a closely held company valued at \$1 million. The trustee splits that stock on a 90/10 basis between the two resulting trusts, leaving the first trust with a 54% interest in the company and the second trust with a 6% interest in the company. Even though a 6% minority interest in a closely held company ordinarily might be entitled to a valuation discount for lack of control (which ordinarily would not apply to a 60% interest or 54% interest), the values attached to the interests in the stock will be \$900,000 and \$100,000, when determining what other assets must be allocated to each trust. This should not affect any valuation discount that was applied to the asset without regard to the severance. So, for example, if the stock owned by the original trust was entitled to a lack of marketability discount, that discount should be taken into account when funding the resulting trusts.

### Additional considerations

**State law issues.** There will be instances where irrevocable trusts do not contain severance authority flexibility, and for which the applicable state statute does not otherwise provide the necessary authority. In those situations, it may be possible to change the situs of the trust so that more flexible state laws apply or to accomplish the severance through a judicial reformation.

Trust reformations normally may be accomplished only by order of a trial court in a judicial proceeding which is valid under state law. The court must have subject matter and personal jurisdiction over a trust and its beneficiaries. Jurisdiction over a trust can exist simultaneously in many states. A state's jurisdiction may be based on the fact that a single trustee or beneficiary resides in the state, trust property has a situs in the state, the grantor of the trust was a resident of the state when the trust was created or became irrevocable, or the trust expressly invokes the jurisdiction of the state's courts.

Historically, as a matter of substantive law, reformation has not been allowed when it is sought merely because the trustee or beneficiaries or even the grantor are no longer pleased with the trust's contents. Before reformation will be granted, it must be established that (1) a change in circumstances has occurred which (2) was not anticipated or foreseen by the creator of the trust, and which (3) results in a frustration of an important purpose of the trust. Traditionally, a second ground for reformation is clear and convincing evidence that a trust or provision within a trust was based on a mistake in fact or law on the part of the trust creator.

In practice, many state courts are willing to modify or reform irrevocable trusts where all parties are in agreement and no clear intention of the settlor is violated by the change. Many state jurisdictions, as well as nationally recognized treatises on trust law, have moved towards a relaxation of the historic barriers to reformation, especially to achieve the donor's presumed intention to minimize taxes, without a showing of a changed circumstance or mistake of law or fact. Given the likelihood that there will be no objection from any interested party, it seems reasonable to assume that a court would look favorably on a petition to sever a trust for GST purposes. While it is always possible that the IRS might challenge a severance ordered by a lower state court that is contrary to state precedents under the Bosch 12 rule, that seems unlikely given the apparent public policy to facilitate severances.

A reformation might also be useful after a qualified severance of a trust. Although one requirement of a qualified severance is that the beneficiaries of the resulting trusts have the same succession of interests as in the original trust, there is no requirement that those interests cannot change at a later date.

For example, assume there is a partially GST-exempt trust that pays all its income on a mandatory basis to a child of the transferor. The child needs income to be distributed to her. The trustee could sever the trust into exempt and nonexempt trusts. The trustee might then invest the exempt trust in assets that do not generate much income, and seek reformation to change the nonexempt trust into a unitrust (or employ a state statute that would permit a nonjudicial conversion) that would increase the amount and predictability of the income cash flow to the child. In this manner, the exempt portion could grow while the child would still receive sufficient distributions from the nonexempt trust to maintain her lifestyle.

*GST tax vs. estate tax.* Of course, a qualified severance still may leave significant assets in a trust that is not GST exempt. In the past, it was fairly common to subject a nonexempt trust to estate tax in order to eliminate any GST tax that might otherwise be owed. Because the estate tax rate could not exceed the GST rate, it seemed like this was a no-lose proposition. This often is no longer the case.

The state death tax credit was eliminated (over several years which have now passed) by EGTRRA. Many states have retained their own separate state death taxes. In those cases, the use of a general power of appointment to trigger estate tax rather than GST tax would be counterproductive. Although the state death tax is now deductible for federal estate tax purposes, that saves less federal tax than the "dollar for dollar" credit previously saved. The result is that total federal and state death taxes for the estate may be higher than the taxes incurred if the GST tax applies.

Apart from the possibly lower overall taxes, there may be other reasons to prefer the GST tax rules over the

estate tax rules. For example, it is well-recognized that a marital deduction trust is more of a tax deferral device than a tax avoidance tool. Similar tax deferral can be obtained, but with more flexibility, with a continuation of a trust subject to the GST tax after the death of a child, with the spouse of the child as a permissible "spray" beneficiary along with the child's children. Because the spouse is assigned to the same generation as the child, the GST tax is deferred until the spouse's death, similar to a marital deduction trust. Yet, unlike a marital deduction trust, the continued GST trust would not be required to pay out all income to the spouse and could retain nonproductive assets (for example, closely held family assets), regardless of the wishes of the surviving spouse.

Even in the pre-EGTRRA days, it was sometimes advantageous to subject property to GST tax and then have the property entirely skip one or more generations (a so-called double skip). For example, at a child's death, a trust created by the child's parent could be subjected to GST tax and then skip to the original transferor's great-grandchildren. Since the trust property would escape tax at the generation of the original transferor's grandchildren, this planning would result in significant transfer tax savings when compared to subjecting the property to estate tax at the child's death and additional transfer taxes at the grandchildren's deaths. Exhibit 1 shows the relative differences in these approaches.

The 17% tax shown in Exhibit 1 assumes the child appointed the assets at death directly to the great-grandchildren of the original transferor. Since this would be a direct skip, the GST tax would be calculated on a tax-exclusive basis. If the assets were left to the grandchildren and taxed again at 45%, only about 30% of the property would be left for the great-grandchildren. When state death taxes are considered, the advantage often is even larger.

## Conclusion

The final and new Proposed Regulations provide important planning opportunities. State law issues still must be carefully considered, and the planning process should not stop once severance has been accomplished. Many planning options are still available for trusts subject to the GST tax, and—particularly for larger estates—the tax savings and other planning opportunities available under a GST tax regime may be superior to those available under an estate tax regime.

## End Notes

<sup>1</sup> REG-145987-03, 69 Fed. Reg. 51967 (8/24/04). See Bieber and Hodgman, "The Kindest Cut of All—Proposed Regs. for Making Qualified GST Severances," 32 ETPL 3 (Mar. 2005).

<sup>2</sup> TD 9348 (8/1/07).

<sup>3</sup> REG-128843-05 (8/1/07).

<sup>4</sup> See Reg. 26.2642-6(b).

<sup>5</sup> See Reg. 26.2642-6(d).

<sup>6</sup> *Id.*

<sup>7</sup> See Reg. 26.2642-6(d)(5) .

<sup>8</sup> See Reg. 26.2642-6(e).

<sup>9</sup> Reg. 26.2642-6(g)(2).

<sup>10</sup> Prop. Reg. 26.2642-6(d)(7)(ii).

<sup>11</sup> Prop. Reg. 26.2642-6(d)(4).

<sup>12</sup> Estate of Bosch, 19 AFTR 2d 1891, 387 US 456, 18 L Ed 2d 886, 67-2 USTC ¶12472, 1967-2 CB 337 (S.Ct., 1967).

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